

Policy and
Oversight




Financial and Performance Audit
Directorate
Quality Control Review

Ernst & Young LLP
Analytic Services Inc.
Fiscal Year Ended September 30, 1996

Report Number PO 97-051

September 26, 1997

Office of the Inspector General
Department of Defense

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Acronyms

AICPA	American Institute of Certified Public Accountants
ANSER	Analytic Services Inc.
DoD	Department of Defense
GAAS	Generally Accepted Auditing Standards
GAS	Government Auditing Standards
OMB	Office of Management and Budget
R&D	Research and Development



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September 26, 1997

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SUBJECT: Quality Control Review of Ernst & Young LLP
Analytic Services Inc.
Fiscal Year Ended September 30, 1996
Report No. PO97-051

Introduction

We are providing this report for your information and response. The Washington, D.C., office of the firm of Ernst & Young LLP performed the single audit for Analytic Services Inc. (ANSER), Arlington, Virginia, a not-for-profit corporation engaged in providing studies and analyses for scientific, educational, and charitable purposes for the public welfare and national defense. The audit is required by the Office of Management and Budget (OMB) Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions." For the fiscal year ended September 30, 1996, ANSER reported total Federal expenditures of \$49,245,140 representing \$47,624,636 for the Department of Defense (DoD) and \$1,620,504 for other Federal agencies.

Ernst & Young LLP issued its audit report November 27, 1996, which includes individual reports on the financial statements and Schedule of Federal Awards, internal controls, and compliance. The auditors questioned no costs and issued an unqualified opinion on the financial statements, Schedule of Federal Awards, and compliance with

specific requirements applicable to major programs. Ernst & Young LLP issued positive and negative assurance statements on compliance with general requirements. Positive assurance states that, with respect to the items tested, the results of the auditors' procedures disclosed no material instances of noncompliance. Negative assurance states that, with respect to the items not tested, nothing came to the auditors' attention that caused them to believe that ANSER had not complied in all material respects. The auditors also obtained an understanding of the internal controls related to the financial statements and Federal awards. The audit report describes the auditors' scope of work in obtaining that understanding and in assessing control risk. The report on internal controls further describes the significant internal controls and control structure, including the controls that provide reasonable assurance that Federal awards are being managed in compliance with applicable laws and regulations.

Quality Control Review Results

The OMB Circular A-133 audit performed by Ernst & Young LLP generally met the applicable guidance and regulatory requirements in OMB Circular A-133, its related Compliance Supplement, Government Auditing Standards (GAS), Generally Accepted Auditing Standards (GAAS), and the provisions of the Federal award agreements for the financial statements, internal controls, and compliance requirements. However, we noted noncompliance with GAS, in relation to continuing professional education, and with OMB Circular A-133, in relation to the Schedule of Federal Awards. See a discussion of our findings below.

Material Findings

Continuing Education Requirements

Two of the four Ernst & Young LLP professionals associated with the audit did not fully comply with the GAS continuing education requirements. They are the engagement partner and the partner who conducted the independent review.

The first general standard in the GAS, 1994 Revision, chapter 3, paragraph 3.3, states, "The staff assigned to conduct the audit should collectively possess adequate professional proficiency for the tasks required." Paragraph 3.6 requires an audit organization to have a program to ensure that its staff maintains professional proficiency through continuing education and training. Specifically, each auditor responsible for planning, directing, conducting, or reporting on audits covered by GAS should complete, every 2 years, at least 80 hours of continuing education and training that contributes to the auditor's professional proficiency. A minimum of 20 hours is required to be completed in any 1 year of the 2-year period. Paragraph 3.6 states that at least 24 of the 80 hours of continuing education and training should be in subjects

directly related to the Government environment and to Government auditing. The GAS further explains that auditors should receive training in any specific or unique environment in which the audited entity operates.

Although all 4 of the Ernst & Young LLP auditors met the 80-hour and 20-hour continuing education requirements discussed above, none of them had 24 hours of continuing education and training in subjects directly related to the Government environment and to Government auditing. GAS "Interpretation of Continuing Education and Training Requirements," April 1991, paragraphs 12 and 13, explain that individuals responsible for conducting substantial portions of field work are required to meet the above mentioned 24-hour requirement if, in a given continuing professional education year, their time chargeable to GAS audits is 20 percent or more of their total chargeable time. The 20-percent threshold is not applicable if the individual spent time planning, directing, or reporting on a GAS audit. The Ernst & Young LLP Senior Auditor spent less than 20 percent of her chargeable time for the continuing professional education year on engagements conducted in accordance with GAS. Ernst & Young LLP asserts that the Senior Auditor spent all her time on GAS audits conducting substantial portions of the field work. If the Senior Auditor was directly involved in planning, directing, or reporting on GAS audits, the Senior Auditor would have been required to meet the 24-hour requirement. The fourth Ernst & Young LLP representative was a new hire and was not required to be in full compliance with the requirements. However, both the engagement partner and the partner who conducted the independent review had responsibility related to planning, directing, and/or reporting that mandate compliance with the continuing professional education requirements in GAS.

In performing an audit in accordance with OMB Circular A-133 requirements, the auditor assumes certain testing and reporting responsibilities beyond those of an audit performed in accordance with GAAS. Those responsibilities focus on the Schedule of Federal Awards, compliance with laws and regulations applicable to Federal awards, and the internal control structure used in administering Federal awards. Therefore, when an auditor undertakes an OMB Circular A-133 audit, the auditor must be knowledgeable of GAS and the applicable audit guides, audit procedures, statutes, rules, and regulations to conduct the necessary tests and procedures to afford a reasonable basis for the audit opinions.

Schedule of Federal Awards

The Schedule of Federal Awards in the Ernst & Young LLP audit report does not fully comply with the applicable requirements. We take exception to the method of presentation of the awards in the Schedule of Federal Awards and not to the substantive testing performed related to the Federal awards.

ANSER is responsible for preparing the Schedule of Federal Awards in accordance with OMB Circular A-133. Ernst & Young LLP is required to audit the information in the Schedule, which should identify major programs, as defined by OMB Circular A-133, and show the total expenditures for each program. Although ANSER has Federal awards for research and development (R&D), the Schedule of Federal Awards does not identify them as R&D and does not group them as a category of Federal awards. As a result, ANSER incorrectly identified large individual R&D awards as major programs instead of combining the sum of expenditures from R&D awards received and presenting R&D as a major program. The applicable requirements are presented in the March 1990, OMB Circular A-133, Attachment, paragraph 1.i., definition of "Major Program," and paragraph 15.c.(1) concerning the Schedule of Federal Awards. Additional clarification is presented in the President's Council on Integrity and Efficiency, Position Statement No. 6, "Questions and Answers on OMB Circular A-133," May 1992, items 24 (Program Definition); 25 (Major Program Test); and 29 (Schedule Presentation of R&D, Student Financial Aid, Individual Awards).

Additionally, the Schedule of Federal Awards does not identify Federal funds passed through from other recipients as pass-through funds. The President's Council on Integrity and Efficiency, Position Statement No. 6, item 29, recommends such identification along with the name of the awarding organization, the program identifying number, and the Catalog of Federal Domestic Assistance number. The identification of pass-through funds facilitates Federal oversight responsibilities over the audits of direct Federal funds and enables prime recipients to monitor the funds they award to subrecipients. Also, identification of pass-through funds facilitates appropriate compliance testing by the auditors.

Report of Independent Auditors on the Consideration of Internal Control Structure Used in Administering Federal Awards

The Report of Independent Auditors on the Consideration of Internal Control Structure Used in Administering Federal Awards requires revision to show the correct percentage of total Federal awards expended under major programs. The revision must be made after the Schedule of Federal Awards is corrected to reflect the major program R&D.

The independent auditors' report also requires revision to include the correct definition of a material weakness as presented in the American Institute of Certified Public Accountants (AICPA), Statement of Position 92-9, "Audits of Not-for Profit Organizations Receiving Federal Awards," December 18, 1995, Exhibit D-8, "Report on the Internal Control Structure Used in Administering Federal Awards," Note 7. The existing report includes certain language appropriate for inclusion in a "Report on the Internal Control Structure Based on an Audit of Financial Statements Performed in Accordance with GAS," which differs from the language required for the existing report. Accordingly, the following paragraph should replace the penultimate paragraph included in the existing Ernst & Young LLP report.

Our consideration of the internal control structure policies and procedures used in administering federal awards would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal awards program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

Immaterial Finding

Management Representation Letter

At our request, ANSER took prompt corrective action to supplement its management representation letter to Ernst & Young LLP. The supplemental letter included management representations to the auditors concerning Federal awards. The additional management representations are required by Statement of Position 92-9, paragraph 6.84. The AICPA, Statement on Auditing Standards No. 19, also addresses client representations. Future management representation letters should include all the required written representations that form a part of the evidential matter needed by independent public accountants to form a reasonable basis for their opinions.

Recommendations for Corrective Action

1. We recommend that Ernst & Young LLP management:
 - a. Take action to ensure that auditors responsible for planning or directing an audit, conducting substantial portions of field work, or reporting on an audit covered by Government Auditing Standards, complete at least 24 of the 80 hours of continuing education and training in subjects directly related to the Government environment and to Government auditing.
 - b. Review the Analytic Services Inc., corrected Schedule of Federal Awards and issue a revised audit opinion, if required.
 - c. Revise the Report of Independent Auditors on the Consideration of Internal Control Structure Used in Administering Federal Awards to:
 - (1) Show the correct percentage of total Federal awards expended under major programs.

(2) Include the correct definition of a material weakness as presented in the American Institute of Certified Public Accountants, Statement of Position 92-9, Exhibit D-8, Note 7.

2. We recommend that Analytic Services Inc.:

a. Correct its Schedule of Federal Awards so that it fully complies with the requirements of Office of Management and Budget Circular A-133. The corrected schedule should present Research and Development as a major program.

b. Identify pass-through funds from direct funds in the Schedule of Federal Awards.

c. Provide the corrected Schedule of Federal Awards to each Federal agency that provided direct awards and to all prime recipients who passed through Federal funds to Analytic Services Inc.

d. Provide the Ernst & Young LLP revised Report of Independent Auditors on the Consideration of Internal Control Structure Used in Administering Federal Awards to each Federal agency that provided direct awards and to all prime recipients who passed through Federal funds to Analytic Services Inc.

Quality Control Review Objective

The objective of a quality control review is to assure that the audit was conducted in accordance with applicable standards and meets the auditing requirements of OMB Circular A-133. As the oversight agency for ANSER, we conducted a quality control review of the audit working papers. We focused our review on the following qualitative aspects of the audit: due professional care, planning, supervision, independence, quality control, internal controls, substantive testing, general and specific compliance testing, and the Schedule of Federal Awards.

We reviewed the most recent peer review letter, dated November 13, 1995, issued by KPMG Peat Marwick LLP, which found that Ernst & Young LLP met the objectives of the quality control review standards established by the AICPA and that the standards were being complied with during the fiscal year ended June 30, 1995.

Scope and Methodology

We used the 1991 edition of the Uniform Quality Control Guide for Single Audits (the Guide), which was approved by the President's Council on Integrity and Efficiency as guidance for performing the quality control review procedures. The Guide is organized

by the general and field work audit standards and the required elements of a single audit. The Guide is further divided into the substantive work performed during the audit of the financial statements and the specific program compliance testing for major programs. In addition, we supplemented the Guide to include additional review of transaction testing. We conducted our review in August 1997.

Results of Prior Quality Control Reviews

We identified minor quality control review findings and recommendations at four of the six Ernst & Young LLP locations we visited from January 1, 1995, through December 31, 1996. The affected offices were notified, and no further action is necessary.

Background

The Inspector General Act of 1978, Public Law 95-452, prescribes the duties and responsibilities of that office. In implementing those responsibilities, the Inspector General is required to "take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General."

The Single Audit Act of 1984 (Public Law 98-502) was intended to improve the financial management of state and local governments whose annual expenditures total \$100,000 or more with respect to Federal financial assistance programs; establish uniform requirements for audits of Federal financial assistance; promote efficient and effective use of audit resources; and ensure that Federal departments and agencies rely on and use the audit work done under the Act, to the maximum extent practicable.

The Single Audit Act Amendments of 1996, based on 12 years of experience under the 1984 Act, are intended to strengthen the usefulness of single audits by increasing the audit threshold from \$100,000 to \$300,000 with respect to Federal financial assistance programs before an audit is required under the Act, by selecting programs to be audited on the basis of risk assessment rather than the amount of funds involved, and by improving the contents and timeliness of single audits. The Amendments also bring nonprofit organizations, previously covered by similar requirements in OMB Circular A-133, under the Single Audit Act.

OMB Circular A-133 establishes the Federal audit and reporting requirements for nonprofit and educational institutions. It provides that an audit made in accordance with the Circular shall be in lieu of any financial audit required under individual Federal awards. An agency must rely on the audit to the extent that it provides the information and assurances that an agency needs to carry out its overall responsibilities. The independent public accountant, Federal auditor, and other non-Federal auditors

must consider each other's work in determining the nature, timing, and extent of their respective audit procedures. The Circular also requires that the cognizant agency obtain or conduct quality control reviews of selected audits made by non-Federal auditors and provide the results, when appropriate, to other interested organizations. When the OMB has not assigned a cognizant agency, then the Federal agency that provides the predominant amount of direct funding to a recipient is designated as the oversight agency. The oversight agency is responsible for providing technical advice to institutions and independent auditors when requested by the recipient and may assume all or some of the responsibilities normally performed by the cognizant agency. The revised Circular was issued June 24, 1997, to incorporate the changes in the Single Audit Act Amendments of 1996. Its provisions apply to audits of fiscal years beginning after June 30, 1996.

Discussion of Results

During our quality control review, we reviewed and took no exception to the working papers supporting the following reports and schedules.

Report of Independent Auditors. The auditor is required to obtain reasonable assurance about whether the financial statements are free of material misstatement. The auditor is also required to subject the Schedule of Federal Awards to the auditing procedures applicable to the audit of the financial statements and to express an opinion regarding whether the information in the schedule is fairly presented in relation to the financial statements taken as a whole. We reviewed the audit program and the testing of evidential matter to determine whether testing was sufficient, based on assessment of control risk, to warrant the conclusions reached and whether the working papers support the conclusions.

Report of Independent Auditors on the Internal Control Structure Based on an Audit of the Financial Statements in Accordance with Government Auditing Standards. The auditor is required to obtain an understanding of the internal control structure that is sufficient to plan the audit and assess control risk for the assertions embodied in the financial statements. We reviewed the audit program for the appropriate procedures, the working paper documentation, and the substantive testing performed.

Report of Independent Auditors on Compliance with Applicable Laws and Regulations in Accordance with Government Auditing Standards. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on the determination of financial statement amounts. We reviewed the audit program for the appropriate procedures, the working paper documentation, its support, and the compliance tests performed.

Report of Independent Auditors on Compliance with General Requirements. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. General requirements are those that could have a material effect on the recipient's financial statements including those prepared for Federal programs. The auditors' procedures were limited to those prescribed in the OMB Circular A-133 Compliance Supplement. We reviewed the audit program for the appropriate procedures, compared the audit program steps with those in the Compliance Supplement to make sure that the appropriate areas were audited, reviewed the working paper documentation and its support, reviewed the compliance tests performed, and reevaluated selected compliance items.

Report of Independent Auditors on Major Program Compliance with Specific Requirements. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on its major Federal programs. The requirements included types of services allowed or unallowed, cost allocation, claims for advances and reimbursements, special reporting requirements, and special tests and provisions. We reviewed the audit program for the appropriate procedures, compared the audit program steps with those in the Compliance Supplement to make sure that the appropriate areas were audited, reviewed the working paper documentation and its support, reviewed the compliance tests performed, and reevaluated selected compliance items.

Report of Independent Auditors on Specific Requirements Applicable to Nonmajor Program Transactions. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its nonmajor Federal programs that were tested during the financial statement audit. We reviewed the audit program for the appropriate procedures, compared the audit program steps with those in the Compliance Supplement to make sure that the appropriate areas were audited, reviewed the working paper documentation and its support, and reviewed the compliance tests performed.

Schedule of Findings and Questioned Costs. Ernst & Young LLP did not have findings or questioned costs.

Comments

Because this report contains findings and recommendations, written comments are required by November 28, 1997. We appreciate the courtesies extended during the review. If you have questions on this report, please contact Ms. Barbara Smolenyak, Program Director, at (703) 604-8761 or Mr. Steven E. Zane, Project Manager, at (703) 604-8772. See the Enclosure for the report distribution.

A handwritten signature in black ink, appearing to read "Russell Rau", with a stylized flourish at the end.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

Enclosure

Analytic Services Inc.
Fiscal Year Ended September 30, 1996

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